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The usual effect of the attempts of government to encourage consumption, is merely to prevent saving; that is, to promote unproductive consumption at the expense of reproductive, and diminish the national wealth by the very means which were intended to increase it.

What a country wants to make it richer, is never consumption, but production. Where there is the latter, we may be sure that there is no want of the former.

— John Stuart Mill, "Of the Influence of Consumption on Production,"
Essays on Some Unsettled Questions of Political Economy, 1830

IT IS FAR WORSE THAN IN 2000

Inspired by optimistic forecasts for the world economy, including lately from the International Monetary Fund, global commodity speculation is running amok. Since the opportunities to make quick and big profits in the markets have become rare after the Fed's rate hikes, the large speculative community has jumped with a vengeance on the commodity bandwagon.

At the same time, U.S. stocks had their best rise in years. Expectations that the Fed's rate hikes are close to their end certainly played an important role in animating spirits. But overall, investors — like economists — also seem to see a cloudless sky, with inflation on the low side but economic growth and profits on the high side.

We have to admit to be pursuing this scenario in the markets and the accompanying discussion with growing amazement. Presently the most important question for the world economy is the unraveling of the housing and consumption bubbles and their possible or probable adverse implications for the U.S. economy and, further on, for the world economy.

But this question seems to find zero interest, apparently due to a general, steadfast assumption that the Federal Reserve has everything under control. Apparently, the consensus sees little more than a moderate slowdown of the housing bubble that does not seriously affect the consumer and his spending binge. To be precise, what we really observe is complete absence of any thinking about this question. There is just the familiar complacency.

Our own assessment of the economic situation starts with the recognition that the U.S. economy is in every possible respect in far worse shape today than it was in 2000. Stating this, we look at new negative records in personal and national savings, in the trade deficit, in debt levels and in income and employment growth. In 2001, the Fed managed to offset the economic and financial carnage from the bursting equity bubble by inflating the housing bubble. But what is the alternative this time?

"The U.S. economy entered the year with strong momentum, particularly in consumer spending. Data released for the first three months of the year point to healthy GDP growth of about 5.1% in the first quarter. However, slowing housing market activity and a moderation in consumer spending is likely to weigh on growth going forward. We expect GDP growth to slow to 2.6% in Q2."

This is the quotation from a research organization that we highly appreciate. We have chosen to quote it because it seems indicative to us of the generally prevailing unconcern about the U.S. economy's actual shape and further prospects after five years of the most unbalanced bubble-driven economic growth.

In particular, an unexpectedly strong retail figure for January triggered talk of an accelerating U.S. economy. But that was the first strong figure after six months of decline and stagnation, and since then it is down again. Actually, the figures from the Bureau of Economic Analysis published under the releases of Personal Income and Outlays show a quite different picture. They show an increase by 0.3% in chained dollars for January and 0.1% for February. That is 2.4% annualized.

Strikingly, November and December of 2005 stand out with strong increases. But they owed their strength largely to extremely favorable inflation adjustments. In November, consumer outlays rose, in chained dollars, at a record rate of 0.9%, as against only 0.5% in current dollars. And in December, chained and current dollar growth rates were at par. By these figures, consumer spending has sharply slowed in 2006.

The consensus forecast for real GDP growth in the first quarter of 2006 is for about 5% at annual rate. For sure, this will be trumpeted as sensational news. But if not annualized, it would be 1.25%, as against 0.4% in the prior quarter, and that hardly appears sensational.

It is with great aversion that we delve into these details, but that is what the public discussion is all about. It has been and remains our basic view that the U.S. economy's pattern of growth — so-called asset-driven growth — that has developed since 2001 under the Fed's manic monetary looseness is of extremely precarious and definitely unsustainable nature.

AN UNPRECEDENTED SHORTFALL

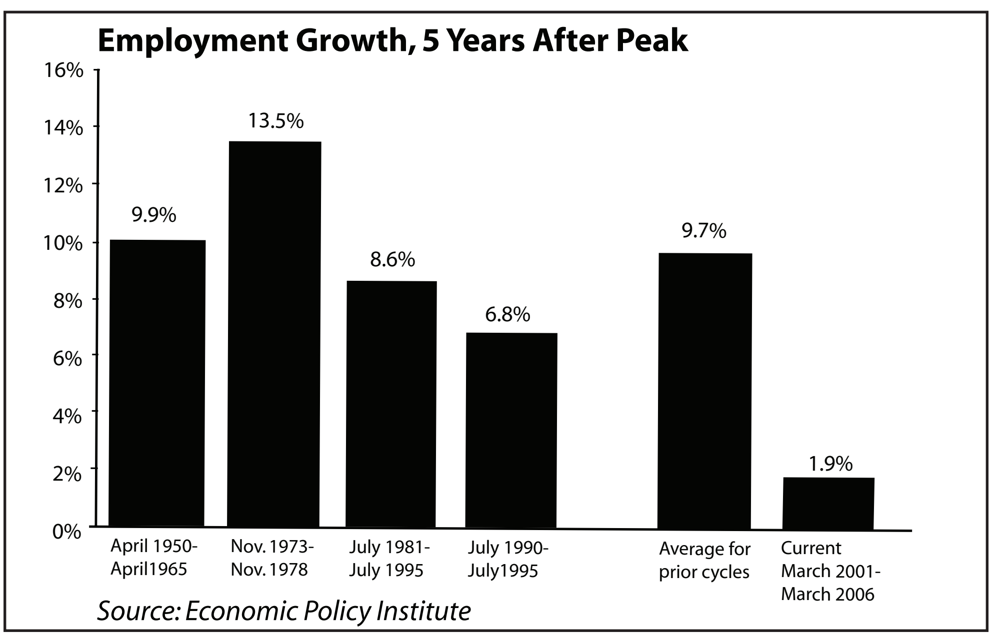
A key consideration for us is that the dramatic income shortfall of the past few years remains in full force. Real disposable income edged up by 1.4% in 2005, compared with a simultaneous spending increase of 3.5%. For the first three months of 2006, the official figures show a rise of real disposable income by 0.3%, or 1.2% at annual rate.

It ought to be realized that this tremendous discrepancy between income growth and spending growth represents a hazardous economic and financial imbalance — and a horrendous policy fiasco.

It should be clear that in due time one of two possible things has to happen: Either the lagging income growth has to catch up with the faster spending growth, or else the latter will adjust to the slower income growth.

The good news is that employment growth appears to have settled in line with the current labor force growth. But it is not enough to absorb the big gap in employment growth that has accumulated over the past few years.

According to the Economic Policy Institute in Washington, employment is up a mere 1.9% over the five years



since March 2001, the beginning of the last recession. This compares with an average employment increase of 9.7% during prior postwar cycles.

THE CRUCIAL LAGGARD: BUSINESS INVESTMENT

Employment and income growth have been the most conspicuous laggards in the U.S. economy's present recovery. In both its pattern and its driving force, it is the strangest economic recovery in history. Policymakers and economists have come to speak of "asset-driven" growth as a new normality posing no particular problem. The questions of underlying causes and long-term implications find zero interest.

With these two questions in mind, we identified another major laggard of undoubtedly crucial importance in the U.S. economy. That is an extraordinary sluggishness in business fixed investment. After a sharp fall, it only recovered its peak level of 2000 in early 2004.

With big tax incentives, business fixed investment bounced back during the year, but has distinctly slowed again in 2005. A turn for the better is definitely not in sight. Rather, the contrary. Manufacturers' real new orders for nondefense capital goods are 18.7% below their 2005 peak.

To put the unusual weakness of nonresidential fixed investment into perspective: In 2005, it was up 4.6% against 2000. This compares with a gain in residential building by 34.7%, in consumer spending by 16.6% and in government spending by 15.4%.

But beware: As weak as the investment figures are, they need a strong qualification. More than the whole reported increase accrues from hedonic pricing of computers. In current dollars, business spending on computers rose 4.2%, but hedonic pricing turned this into a boom-like increase by 104%. Nonresidential investment in structures was down 20% and investment in industrial equipment 7%.

BUSINESSES — THE SPENDER OF LAST RESORT

American policymakers and economists notoriously look at consumer spending as the main driver of economic growth, apparently determined by two assumptions. Manifestly, it accounts by far for the greatest part of GDP, actually 71% in the United States. The government ranks second with about 18%, and business fixed investment third with a share of about 11%. A second traditional argument emphasizing the dominant role of consumer spending in economic activity is its role as "final" demand in the economy. In the last resort is not all production for consumption?

At the very least, it sounds very plausible. Yet it does not make any sense. One single question and consideration is apt to expose this idea about consumer spending as nonsense: What is the source of the money that consumers generally spend? In short, it is wages and salaries paid by businesses. Where would consumer spending be without business hiring?

An even greater error is the common habit to measure business spending only by the investment figures. It is only a small part of business spending because the GDP accounts capture only spending on "final goods and services." The word "final" is important. The vast productive process in an economy consists of a long succession of operations through which materials pass from the raw to the finished state.

But what enters GDP are only the *final* products, which emerge from the long production process. All the business spending on *intermediate* products is omitted to avoid double counting. By definition, consumer spending is in total of *final* nature. But in the case of business spending, this applies only to the small component of investment spending.

The Bureau of Economic Analysis only publishes the data for business spending on "intermediate input" in greater intervals. The last available figures for 2004 show a total of $9,611.8 billion. Together with business spending on fixed investment of $1,198.8 billion, this adds up to $10,810.6 billion, as against consumer spending of $8,211.4 billion.

THE U.S. CONSUMPTION BIAS

In general, the high esteem of American policymakers and economists for consumer spending as the motor of economic growth is attributed to the influence of Keynes. In reality, it originates in the early 1920s, long before Keynes, in America itself. American Keynesians later ascribed it to Keynes.

This thinking originates in a bizarre episode involving leading American economists. In the early 1920s, two until then completely unknown persons began to write a whole series of books that all propagated the idea that the capitalistic economy was chronically threatened by a lack of consumer income and demand. Their names were William Trufant Foster and Waddill Catchings.

Their writing attained the widest circulation in the United States and was accepted in universities. Among the books they published between 1923–28 were titles such as *Profits; The Dilemma of Thrift; Money;* and *Business without a Buyer*. In all these books, they warned of the danger of deflation and agitated for monetary inflation and public works.

To quote two typical remarks: "*Money spent in the consumption of commodities is the force that moves all the wheels of industry*" and "*The one thing that is needed above all others to sustain a forward movement of business is enough money in the hand of consumers.*"

The pair gained particular fame through a campaign that they launched with the explicit intent to "convert economists" by offering a prize for the best adverse criticism of their book *Profits*. An illustrious jury — among them America's top economist professor, Wesley C. Mitchell, and Owen D. Young of "Young Plan" fame and chairman of General Electric — was to choose the best essay.

Among the authors of the essays were 50 professors of economics, 40 authors of books on economics, 60 accounting experts, bankers, editors and some of the "ablest men in the Federal Reserve," etc. A later published collection of the essays revealed that all authors, except two, had unreservedly accepted the main thesis of Foster and Catchings that there exists a chronic bias in the economy toward a chronic deficiency of consumer purchasing power. Any objections were directed against minor details. (This episode is described in great detail by Friedrich Hayek in *Profits, Interest and Investment*, London, 1939.)

They proposed for every crisis a (for the time) revolutionary solution: "*It would be easy to arrange an increase in consumers' credits; it is only in this way that the deficiency in purchasing power of the consumer, and thus the cause of the Depression, can be removed.*"

We have recalled this episode because it is widely unknown. On the other hand, it strikingly reveals that the American high esteem of consumption as the motor of economic growth has a long tradition. But in particular, it attracted our interest in view of the fact that the U.S. economy in the late 1920s went with an orgy of wealth-driven — the bull market in stocks — consumer credit into the Depression.

EUROPE — CAPITAL INVESTMENT IS THE KEY

Thinking about the business cycle and the possible regular causes really started only at the end of the 20th century. As industrialization progressed, investment spending and employment in the capital goods industries also played a rapidly growing role. A few economists, at first, identified and pointed out the importance of variations in business investment in determining economic activity.

What finally revolutionized thinking about the business cycle and economic growth in Europe was a book from a Russian professor, Dr. Michael Tugan-Baranowski, titled *Theory and History of Trade Cycles in England*, published only in German in 1901. Based on a detailed study of British cycles and crises, he made several revolutionary statements, such as that the ultimate aim of production is not to improve living standards, but the creation of productive capital stock and the pursuit of profits by entrepreneurs.

As to the business cycle, he emphasized the overriding role of variations in the production of capital goods as compared with the even advance of the production of consumption goods. He also, for example, stressed that capital formation and production have their true limit in available saving, not in consumer spending.

Being written in Germany, the new business cycle theory virtually bypassed the English-speaking economists. Yet one admitted a strong influence. In his *A Treatise on Money*, published in 1930, J.M. Keynes explicitly stated: "*I feel myself in sympathy with the school of writers — Tugan-Baranowski, Spiethoff and Schumpeter — of which Tugan-Baranowski was the first and the most original.*"

In his book of more than 400 pages, Tugan-Baranowski analyzed in astonishing detail the various crises that the British economy and its banking system experienced during the 19th century. His conclusion was that every crisis arises from the fact during the boom and the following downturn the "*proportional distribution of the productive forces is deranged.*" Equilibrium of demand and supply is shattered. In the prosperity phase, some branches expand faster than others.

With Tugan-Baranowski, a new way of thinking about the business cycle began in Europe. It became the accepted central idea that economic growth and prosperity depend on autonomous capital investment guided by relative prices and profit expectations.

We have recalled these two episodes in the history of economic thought because they give food for thought about the present situation in the United States. Over the past few years, U.S. policies have boosted private consumption as never before in conformity with the conventional thinking that this must stimulate investment. Its true counterpart is the lowest level of business fixed investment.

It is a common refrain in the reports of American economists that government borrowing tends to crowd out business investment. But its logical correlative that consumer borrowing must essentially have exactly the same negative effect on business investment is never mentioned.

THE NEW U.S. ECONOMY

The policy dilemma currently facing the United States can be simply stated. Economic growth has become completely dependent on consumer spending, and this, in turn, has become completely dependent on rising house prices providing the collateral for the most profligate consumer borrowing. This borrowing has become a necessity because income growth has abruptly caved in. Rock-bottom short-term interest rates and utter monetary looseness were the key conditions fostering altogether four bubbles: bonds, house prices, residential building and mortgage refinancing.

What developed is an economic recovery with an unprecedented array of escalating imbalances: ever-declining personal savings; an ever-widening current deficit; exploding government and consumer debts; and, on the other hand, a protracted shortfall in business fixed investment, employment and available incomes.

We must admit that the staying power of this extremely ill-structured and debt-laden recovery and the stubborn buoyancy of the financial markets have rather surprised us. Under the prevailing conditions of rampant global liquidity excess, there has apparently developed an unprecedented and virtually unlimited tolerance for economic and financial imbalances. Consider that Iceland has a trade deficit of 16% of GDP.

But this only lengthens the rope with which to hang oneself. What American policymakers and most economists studiously keep overlooking is that the credit bubbles are doing tremendous structural damage to their economy. The longer the bubbles last, the greater the damage.

DEBT EXPLOSION VS. INCOME IMPLOSION

This time, we want to focus on the dramatic shortfall of employment and income growth that radically distinguishes this recovery from all its precedents in the postwar period. It must have a particular cause, but where is it? In search of its causes, we contrast, first of all, credit and debt growth with income growth.

Over the five years from 2000–2005, total debt, nonfinancial and financial, has increased $12.7 trillion in the United States. This compares with a simultaneous rise in national income by $2.1 trillion. For each dollar added to income, there were $6 added to indebtedness. In real terms, national income increased little more than $1 trillion.

These figures raise two paramount questions: *First*, what explains this unusually rapid credit expansion? And *second*, what explains the unusually sluggish employment and income growth?

The first question is the easiest to answer, because the overwhelming use of the extended credit is well known. In times of yore, the financial system in any economy served mainly to transform available savings into investment and to allocate those funds among competing users.

Today's financial systems, and in particular that of the United States, have vastly outgrown this traditional role. Financial activity for purely financial purposes, outside the GDP, has gained overwhelming importance. Businesses are running a sizable surplus in their current transactions, yet they borrow heavily for asset purchases, buying growth through mergers and acquisitions. The single biggest item is certainly borrowing for leveraged asset purchases — carry trade.

Yet we see two further reasons for the continuous, extraordinary stampede into debt. One of rapidly growing importance is certainly Ponzi finance, meaning that interest rate charges are not paid but capitalized. We are sure that this is playing a huge and rapidly escalating role. To have some idea about its extent, we make a simple calculation.

Total domestic indebtedness in the United States now amounts to almost $40 trillion. An assumption of average interest rates of 5% is certainly very much on the low side. Still, it implies annual financing costs of around $2 trillion. Given last year an increase in national income by $628 billion, it should be clear that at present debt levels, current financing costs vastly exceed the increases in current income. To meet the difference, lenders capitalize interest rates, adding the sums to outstanding credits.

The explanation is self-evident. Borrowers and lenders don't care about cash flow and current income to meet debt service, because they count on the stability of the underlying asset values. Their stability has become the key question. Considering the vast difference between the growth of national income and the estimated annual financing costs of the debt mountain, we are sure that Ponzi finance is the single biggest item behind the credit expansion in the United States, and it is rising fast. Of course, this money is not for spending in the economy.

Looking for the causes of the current debt explosion in the United States, the monstrous trade deficit finally needs mentioning. There is much talk about its foreign financing. But it requires domestic financing in addition, because it diverts domestic spending to foreign producers, implying a corresponding loss to domestic producers. Essentially, credit creation has to offset this drag.

WHAT SQUEEZES EMPLOYMENT AND INCOME?

Far more difficult is the second question, concerning the unusual, drastic shortfall of employment and income growth in this recovery.

Essentially, this must have its main reason in the economy's most unusual growth pattern. Credit could not have been more abundant, but its effects may differ diametrically from credit expansions in the past. Use of credit for transactions outside the national product for the purchase of existing assets has vastly outpaced the use for spending on goods and services.

In the case of many financial transactions, among them mergers, acquisitions and all types of carry trade, the borrowing and spending evidently adds nothing to the economy's income stream. All this goes a long way to explaining the tremendous divergence between rampant debt growth and sluggish income growth. But it does not go all the way.

This is the obvious part. Few people seem to realize that there is also a diametric difference in economic effects between borrowing for capital investment and borrowing for consumption. After careful scrutiny, we have come

to the following two conclusions:

First, credit for capital investment generates cumulative employment and income growth with minimal debt growth; *second*, credit for consumption generates compounding debt growth with minimal employment and income growth.

Consider what happens when businesses borrow for fixed investment. The first effect is that producing the buildings, the plant and the equipment creates corresponding employment, incomes and tangible wealth. Then, when these capital goods are installed, they create additional supply, employment, productivity and incomes.

Investment spending has distinguishing features that endow it with singular impetus for economic growth: One is that it impacts the economy successively from the demand and supply sides, and the other is that it implicitly creates current and future incomes.

And most importantly, investment spending is through depreciations self-financing and of recurrent nature in the long run. As a rule, depleted plant is rebuilt with new technologies.

Capital spending is really the critical mass in the economic growth process, generating all the things that make for rising wealth and living standards.

Now compare this multitude of effects due to investment spending with the effects of consumer credit. Once spent, their economic effects quickly peter out. Any new increase in spending requires new credit. At the same time, running interest costs either rapidly compound in the balance sheet or reduce current income. Consumer borrowing principally makes economic sense only for people who can look forward to higher future income. But in the United States, it is used for the opposite purpose: to offset missing income growth.

Last year, U.S. private households added $374.4 billion to their disposable income and $1,204.7 billion to their outstanding debts. Inflation-adjusted disposable income grew $115.7 billion. It is a growth pattern with exploding debts and imploding income growth.

To make our point perfectly clear: The present U.S. economic recovery has never gained the traction that it needs for self-sustaining economic growth with commensurate employment and income growth. As to its main cause, all considerations lead to the conclusion that it must reside in the protracted, appalling shortfall in business fixed investment. Investment spending is, really, the essence of economic growth.

UNPRECEDENTED WEAKNESS

Pondering these questions, we increasingly wonder what the Fed truly intends with its rate hikes. As a rule, central banks do this to slow credit and spending. We are sure that the Federal Reserve will immediately stop its rate hikes and quickly ease at the first sign of distinct economic weakness. On the other hand, we note that the credit deluge continues without the slightest abatement. Actually, the unfolding global commodity bubble is a mockery of the Fed's "tightening."

As a matter of fact, we strongly suspect that these rate hikes are primarily a psychological exercise to impress the markets with anti-inflationary resoluteness. In the same vein, the rate hikes create scope for new rate cuts once the economy weakens. For sure, there is not the slightest intent on the part of the Fed to put any restraint on anything in the economy and the financial system. The main danger we see is that the Fed underestimates the economy's vulnerability and triggers an undesired shock.

Plainly, the consensus — including the Fed — sees no serious problem in this development. The apparent general expectation is that house prices may stop rising or even modestly decline; nevertheless, the consumer will be able to maintain his borrowing binge because the wealth creation through rising house prices has kept home equity generally well ahead of the debt increases. Many are hailing household finances as having never been in better shape.

Our own considerations begin with the recognition that the U.S. economy is, in every single respect, in far worse shape today than it was in 2000, and also that there is no other bubble in sight to replace the housing bubble. Everything depends on the housing bubble to rapidly reflate once the Fed eases again.

Nothing seems impossible where blind confidence rules. Yet we regard this as a most improbable outcome. An idea that spooks many is that all markets are drowning in liquidity. That is true — on the way up simply because credit for leveraged speculation is globally available without limit today.

But wait, what will happen to this liquidity when the tide of buying and selling turns? This excess liquidity has its main source in the ability to borrow against rising asset prices. Overwhelmingly, it is borrowed liquidity based exclusively on the expectation of the buyers that there are sufficient "greater fools" out there to buy the assets at still higher prices. If these greater fools fail to appear, there will be a liquidity collapse with price crashes.

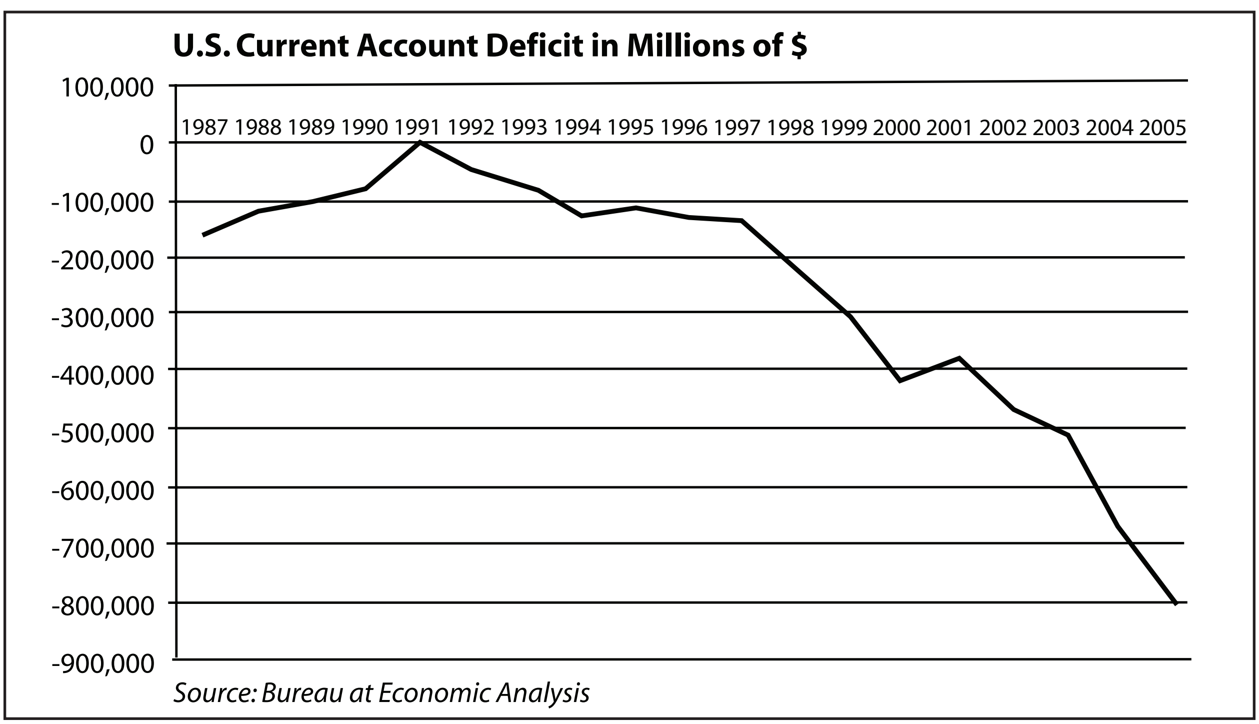
Our strongly held assumption that the U.S. economy is in a most precarious condition basically has two reasons. One is the extravagant size of the housing bubble, involving the whole financial system to an unprecedented extent. The other is the grossly ill-structured economy, replete with imbalances inhibiting sustained economic growth.

A RESTRUCTURED U.S. ECONOMY

It has to be realized that the economic development in the United States has nothing to do with the business cycle. At issue are major changes in the economy's resource allocation, of definitely long-term structural nature. Since the mid-1980s, the primary feature has been the persistent decline of personal savings from 10% of disposable income into negative territory recently. Essentially, this reflects a major shift in the resource allocation toward consumption.

In an economy where consumption takes a rising share of GDP, other components in the economy must accordingly adjust to release the required higher resources for consumer spending. Since the government refuses to do so, this need for adjustment has essentially fallen on two aggregates. One is the U.S. economy's trade balance, and the other one is domestic capital formation and investment spending.

As a rule, the trade balance is the most elastic part in every economy. In the U.S. case, since 1995 the trade deficit has widened from $113.6 billion to an annual rate of $800 billion lately. That is the spectacular part of the



structural adjustment. The other very unspectacular part is the correlated shrinkage of capital investment as a share of GDP, which American policymakers and most economists flatly ignore.

In past letters, we have repeatedly emphasized this negative counterpart to the consumption.

Unexpectedly, we spotted two charts dramatically highlighting this structural debasement of the U.S. economy. They are from a release by the office of former Harvard President Lawrence H. Summers related to a speech in India titled “Reflections on Global Account Imbalances and Emerging Markets Reserve Accumulation.”

The charts make shocking reading: Basically, they show how the U.S. economy has adjusted to the consumer borrowing and spending binge: *first*, by pulling in a rapidly increasing flood of imports, and *second*, by crowding out domestic investment. Manifestly, this reflects a pretty drastic restructuring of the U.S. economy.

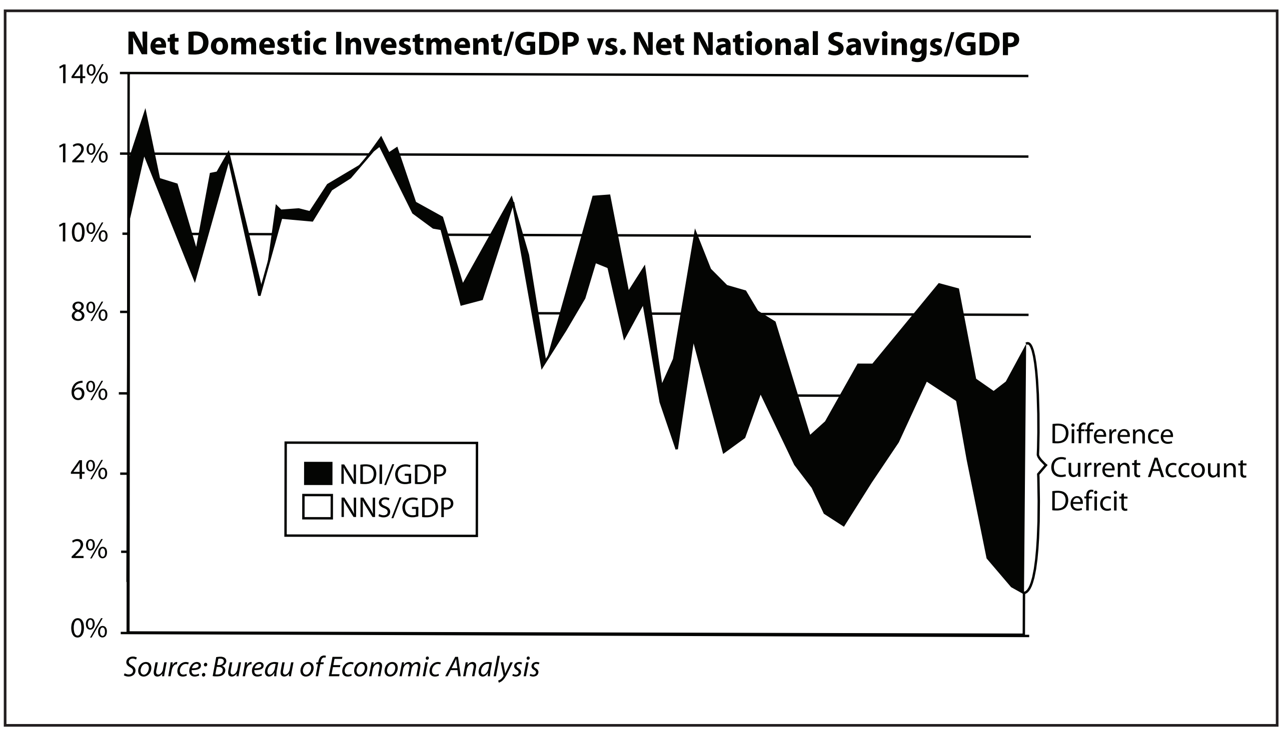
As bad as the investment picture looks, the reality is a lot worse for two reasons. One reason is its composition. Though not explicitly mentioned, the figures include residential and nonresidential building, which have developed very differently.

By official figures, bubble-driven residential investment in 2005 was up a stellar 34.7% from its level in 2000. Nonresidential investment, in contrast, has edged up a mere 4.6%. But all this reported growth in business fixed investment and a lot more has come only from heavy hedonic pricing of computers. In its absence, this investment component would be well below its level in 2000.

However, the lower chart reveals still another shocking perspective. It concerns the relationship between domestic net investment and simultaneous increases in foreign indebtedness. In the early 1990s, net domestic investment hovered between 10–12% of GDP with a minimal trade deficit and capital inflows.

Over the last few years, the increases in the trade deficit and in its wake the foreign indebtedness have soared in relation to domestic net investment. Today net U.S. capital formation — measured by the increase in net domestic investment minus the increase in foreign indebtedness — is close to 1% of GDP.

According to former Fed Chief Alan Greenspan and Wall Street folklore, the sluggish performance of business fixed investment has its temporary main reason in the fact that businesses grossly overinvested in the “new paradigm” years of the late 1990s, particularly in the new high tech. Indeed, the National Income and Product Accounts (NIPA) reported for the three years 1997–2000 a record rise by 42.3% in nonresidential fixed



investment, accounting for 36% of real GDP growth.

To be sure, these fabulous investment figures played a key role in creating the generally prevailing euphoric perception of an ongoing productivity and profit miracle. For a critical observer, this roaring investment boom compared strangely with plummeting savings. Identifying the true source of this investment boom was not difficult: creative statistics.

Over those three years, business spending on computers by businesses actually increased, in current dollars, from $79.6 billion to $109.3 billion, up thus $29.7 billion. Hedonic pricing, however, turned this modest increase into a steep increase from $102.9 billion to $290.3 billion, up $187.4 billion.

A second extraordinary contribution to the "investment boom" came by a stroke of the pen, as the government's statisticians in 1998 decided to take software expenditures out of business expenses and to capitalize it, instead. This added another $68.6 billion to the reported "investment boom" of those years. In short, both components added up to $256 billion. This amount accounted for 75% of the total increase in business fixed investment during these years.

The reality of the U.S. economy's "new paradigm" years was an accelerating consumption boom showing unmistakably and strikingly in the uninterrupted fall of the personal savings rate during the decade. Starting with 8% of disposable income in the early 1990s, it ended in 2000 at 1%.

A PRETTY POOR PROFIT PERFORMANCE

It is more than four decades ago since professor Simon Kuznets, one of America's greatest postwar economists, stated with obvious irritation that the U.S. economy is geared to higher consumption and relatively low savings, and that "*our institutions and patterns of social behavior encourage higher consumption per capita.*" Unfortunately, he failed to express a view about long-term consequences for living standards.

Clearly, over time the U.S. economy has become increasingly geared to consumer spending as its main motor. It started in the 1980s, and proceeded slowly during the first half of the 1990s. But since 1997, and in particular since 2000, it has relentlessly accelerated. Its unmistakable sign has been a falling personal and national savings ratio.

Both in the 1980s and in the late 1990s, the equity bubble drove people to slash their savings from current income in favor of higher spending. In 2001, when the stock market crashed, the Greenspan Fed succeeded in promptly inflating the housing bubble, thereby creating apparent wealth through another route.

Manifestly, policymakers and most economists see no problem in this structural mutation, refusing to see the causal correlation with the weakness in business investment and the soaring trade deficit. Presumably, the big contributions hedonic pricing of computers makes to the reported figures of business investment go a long way to delude people about the ugly truth.

The decisive fact, as explained earlier, is that consumer and investment spending diametrically differ in their effects on the economy, particularly in the long run.

Wondering about chronic weakness of business fixed investment requires a look at profits.

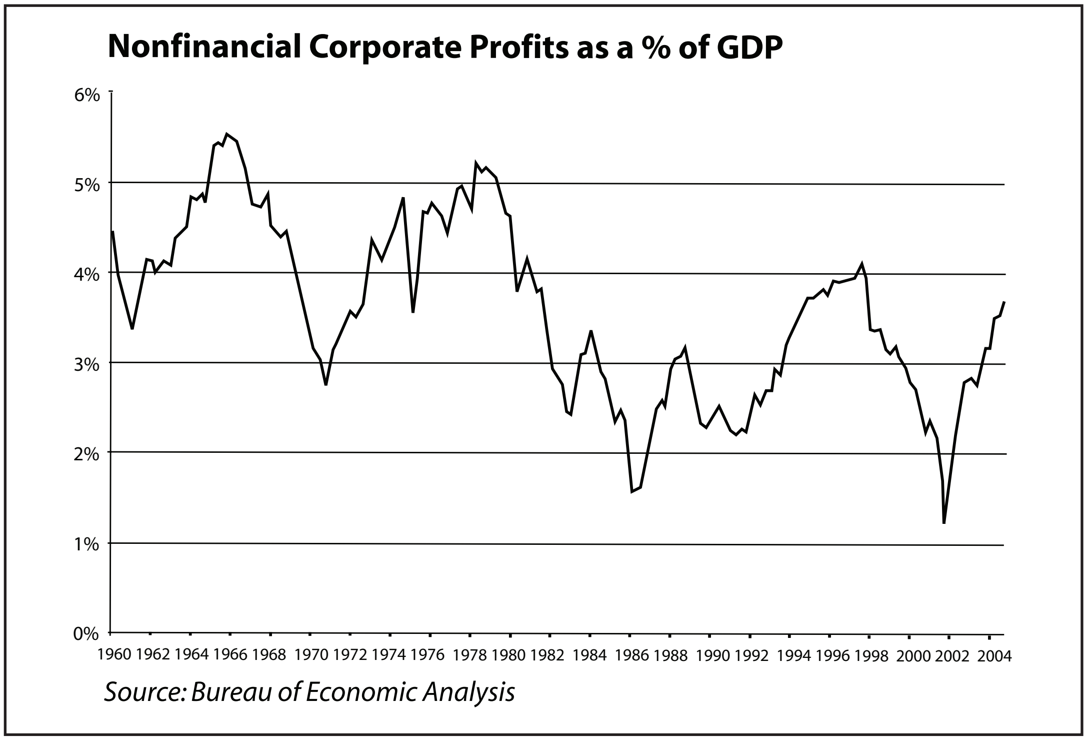
Wall Street, of course, never stops raving about excellent prospects and profit prospects. We stick to the figures as published by the BEA, where options have always been treated as business expenses. Besides, our analysis is principally on the macro level.

Thanks to new accounting rules, starting this month U.S. companies are obliged for the first time to count employee options as expenses, giving many investors their first look at how heavily options have bolstered past earnings.

It is undisputed that profits and profit prospects play a key role in motivating businesses to invest. The

following chart shows the development of nonfinancial profits as a share of GDP.

We would not say that it offers an attractive picture:



Strikingly, there are two very nasty periods. The first one covers the period from 1978–1986, and the second one the years 1977–2002. Ironically, the first period coincided with the best years of America's new supply-side economics and the second one coincided fully three years with the trumpeted "new paradigm" economy rendering productivity and productivity miracles.

The most astonishing profit slump is certainly the one that started in 1997. Actually, profit growth began to slow already in 1995, precisely when the stock market began its frenzied run.

TWO MAJOR PROFIT KILLERS

Strikingly, profits play a very big role in the economic discussion in the United States. The obvious reason is its domination by Wall Street interests. The undisputed general assumption is that the development of profits is mainly governed by two features: productivity growth and corresponding changes in labor costs, on the one hand, and pricing power — inflation rates, in fact — on the other.

Considering that the U.S. nonfarm business sector slashed its labor costs per unit of output by 18% between 2000-05, while the producer price index for finished goods rose 14%, you would think that corporations were rolling in profits. In actual fact, they were barely higher than in 1997. As a percentage of GDP, they were sharply lower.

Where is the fallacy? It lies in the fact that business profits are subject to many influences other than productivity growth and pricing power — most of them, by the way, beyond the influence of single firms.

Principally, aggregate business profits are determined by the difference between aggregate revenues and aggregate business expenses. Though this sounds a banality, it is full of intricacies because business revenues are exposed to very different outside influences, over which single firms have no control. The most important ones currently in the United States are the collapse of personal saving, the shortfall in business investment and the huge and soaring trade deficit.

When private households purchase goods and services with credit, rather than with earned wages and salaries, this fattens business profits because in the aggregate revenues rise relative to business expenses. The consumer borrowing and spending binge of the past 20 years has been a great profit bonanza for U.S. businesses. Unfortunately, it has been increasingly offset by the shortfall in business investment and the soaring trade deficit.

As pointed out earlier, the business sector is the greatest spender in the economy, but among all the spending there is one component of particular importance. Net fixed investment is typically the largest and most important profit source. This has its reason in the fact that it creates business revenue without generating an expense. When a firm purchases machinery, it involves no expenses because it capitalizes this expenditure in its balance sheet. No expense is incurred until the first depreciation charge is recorded. But to the firm that produces and sells these machines, the receipts are revenue for their profit-and-loss account.

For firms in the aggregate, net investment, therefore, means net profit.

We presume that net business fixed investment in the United States after its past plunge is now negative. Again, it needs strong admonitions concerning the heavy hedonic pricing of computers. It creates big contributions to investment spending in recorded real GDP growth, but unfortunately it is spending that only takes place in the GDP statistics. Nobody spends money, and nobody receives money. All the hedonic pricing is totally irrelevant for business revenues and profits.

But there is a second big profit killer at work in the U.S. economy. That is the huge trade deficit. The key point here is that a large part of the money spent on the import surplus of foreign goods comes from wages and salaries earned in the United States. That is, it comes from the expenses of American businesses. As people buy domestic goods, prior business expenses return as revenue. However, this goes awry when people buy foreign goods. The net effect of the U.S. trade deficit is that business revenues fall relative to business expenses.

CONCLUSIONS:

Forecasts for the world economy are generally optimistic in the expectation that the U.S. economy will continue its global pull with continuous strong growth. We think the anemic and extremely unbalanced U.S. economic recovery is in its last gasp.

Our key consideration is that the U.S. economy has become perilously addicted to asset inflation in general and the housing bubble in particular. Both rising asset prices and the rising dollar had their foundation in carry trade of astronomic scale. While interest rates may still appear rather low compared with the inflation rates, the Fed’s rate hikes have pulled the rug from under the dollar-based carry trade.

The rising yen, euro and Swiss franc are doing the same to carry trade in low-interest foreign currencies. It defies imagination how all these carry trade bubbles can be unwound without dramatic reactions in the markets.

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